II.C. Case Analysis

Cases

Introduction

This section provides a brief overview of several abusive tax shelter court cases.

Economic Substance Doctrine - Gregory v. Helvering

Gregory v. Helvering is the case most often cited as the source of the economic substance doctrine. *See Gregory v. Helvering*, 293 U.S. 465 (1935) (addressing the question of whether a tax-free reorganization took place where the taxpayer had no intent to carry on the existing corporate business, only a desire to minimize taxes). In this case, Gregory (the taxpayer) wished to transfer stock from a corporation she wholly owned to herself. Had she done so directly, the transfer would have been treated as a taxable dividend. Instead, in an attempt to avoid taxation, Gregory formed a new corporation, transferred the stock there, liquidated the newly formed corporation, and claimed its assets. She argued that, pursuant to section 112(g) of the Revenue Act of 1928, 45 Stat. 791, 818, this transaction should have no tax consequences because she had received the stock "in pursuance of a plan of [corporate] reorganization." *Gregory*, 293 U.S. at 468. Although the transaction satisfied the literal terms of the statute, the Court sided with the Commissioner, condemning the transaction as an "elaborate and devious form of conveyance masquerading as a corporate reorganization." *Id.*, at 470. The Court determined that to allow Gregory to avoid taxation would be to "exalt artifice above reality and to deprive the statutory provision in question of all serious purpose" *Id.*, at 470. Numerous courts have since cited this case for the general principle that a transaction that lacks substance is not recognized for Federal tax purposes.

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The Merrill Lynch Installment Sale Partnership Transactions

A Merrill Lynch & Co., Inc. ("Merrill Lynch") investment plan is the subject of three cases:

1. *ACM Partnership v. Commissioner*, T.C. Memo 1997-115, *aff'd in part and rev'd in part*, 157 F.3d 231 (3d Cir. 1998), *cert. denied*, 526 U.S. 1017 (1999)
2. *ASA Investerings Partnership v. Commissioner*, T.C. Memo 1998-305, *aff'd* 201 F.3d 505 (D.C. Cir. 2000), *cert. denied* 531 U.S. 871 (2000)
3. *SABA Partnership v. Commissioner*, T.C. Memo 1999-359, *vacated and remanded*, 273 F.3d 1135 (D.C. Cir. 2001).

These cases center on an investment plan that Merrill Lynch had marketed to large U.S. companies. The plan's principal aim was to generate huge capital losses which would then offset existing (or expected) capital gains. At the outset, the plan required that the U.S. company form a partnership (based outside the United States) with a foreign entity that paid no U.S. income tax. This foreign entity would maintain an overwhelming majority partnership interest. By implementing a number of steps and by relying on the installment sale and contingency sale rules, the plan was able to generate huge capital losses. The Merrill Lynch plan generally involved the following seven steps:

1. The U.S. company would enter into a foreign-based partnership with a foreign entity that was not subject to U.S. income tax.
2. The foreign entity would have the overwhelming majority partnership interest while the U.S. company would own a distinct minority interest.
3. The partnership would purchase short-term private placement notes ("PPNs") eligible for the installment method of accounting. It then would sell them for a large cash down payment with the balance made up of a comparatively small amount of debt instruments (five-year Libor notes) whose yield over a fixed period of time was not ascertainable. One-sixth of the basis would be applied to the down payment. The gain from the down payment would be allocated according to the partnership interests. Therefore, the foreign partner would receive the majority of the gain.

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The Merrill Lynch Installment Sale Partnership Transactions

4. The partnership would claim a large basis (five-sixths of the basis of the PPNs) in the Libor notes.
5. After the close of the first tax year, the partnership interests would become substantially reversed. (The U.S. Company would acquire a majority interest by purchasing part of the foreign entity's interest.)
6. The partnership would distribute cash to the foreign entity and the Libor notes to the U.S. partner in partial redemption of their partnership interests.
7. The U.S. company then would sell the Libor notes to a third party, accelerating the loss. Since the basis of the instruments would greatly exceed their value, the sale would result in a large "paper" loss the U.S. Company would use to offset existing capital gains. [1]

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[1] Tina Steward Quinn and Tonya K. Flesher, *A Weapon from the Past*, JOURNAL OF ACCOUNTANCY, July 2002, at 66.

ACM Partnership

The Third Circuit Court of Appeals generally affirmed the Tax Court's decision in *ACM Partnership v. Commissioner*, whereby the lower court held that the economic substance doctrine precluded the partnership's deduction of approximately $85 million of losses attributed to the purchase and contingent installment sale of certain notes. *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), *aff'g,* T.C. Memo 1997-115.

Under the facts of this case, Colgate-Palmolive (the taxpayer) aimed to offset the tax effects of a 1988 multimillion dollar capital gain. In 1989, ABN (a major Dutch bank and the foreign entity involved in all three Merrill Lynch plan cases), Colgate-Palmolive, and Merrill Lynch each created a new company (referred to here as A, C and M, respectively). These three companies then formed the ACM partnership to generate capital losses Colgate-Palmolive could use to offset some of its 1988 capital gains. The partnership was capitalized with $205 million - A held 82.6 percent, C held 17.1 percent, and M held 0.3 percent. ACM used an elaborate series of securities transactions that ultimately resulted in its selling $175 million in PPNs for $140 million in cash and eight Libor notes with a present value of approximately $35 million. Since the total amount was based on a contingency (due to fluctuations in the Libor), ACM treated the transaction as an installment sale, allowing it to "recover" one-sixth of the basis each year over the term of the contract.

The $140 million ACM collected in the year of sale resulted in a $110.7 million gain, which was allocated primarily to partner A. After the close of the first tax year, Colgate-Palmolive purchased part of A's partnership interest. ACM redeemed a portion, leaving Colgate-Palmolive as the majority partner. Subsequent installment payments resulted in capital losses allocated primarily (99.7 percent) to Colgate-Palmolive. In December 1991, the partnership sold the Libor notes, accelerating the remaining loss. Colgate-Palmolive reported total capital losses of more than $98 million over the course of its participation in ACM. It then carried these losses back to offset its 1988 capital gain.

In 1993, the Service challenged ACM's treatment of the transaction and disallowed the use of the installment sale rules, calling it a sham transaction creating "phantom" losses.

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ACM Partnership

The Tax Court found that the taxpayer desired to take advantage of a loss that was not economically inherent in the object of the sale, but which the taxpayer created artificially through the manipulation and abuse of the tax laws. *ACM Partnership v. Commissioner,* T.C. Memo 1997-115. The Court added that the tax law requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction. It held that the transactions lacked economic substance and, therefore, the taxpayer was not entitled to the claimed deductions. *ACM Partnership,* T.C. Memo 1997-115. Thereafter, ACM appealed to the Third Circuit Court of Appeals.

On appeal, the Third Circuit Court of Appeals relied on *Gregory* in applying the substance-over-form doctrine and the business purpose test. *ACM Partnership v. Commissioner,* 157 F.3d 231 (3d Cir. 1998). The Court viewed the transactions as a whole, as well as each step from beginning to end, to determine if they had sufficient economic substance to be respected for tax purposes. Ultimately, the court found ACM's transactions had only nominal, incidental effects on the partnership's net economic position. The court emphasized, "Gregory requires us to determine the tax consequences of a series of transactions based on what actually occurred," and it affirmed the Tax Court decision that ACM's transactions lacked economic substance. *ACM Partnership,* 157 F.3d at 250.

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ASA Investerings Partnership

In *ASA Investerings Partnership*, involving a similar transaction to that of *ACM Partnership*, the Tax Court focused on the validity of the partnership. *ASA Investerings Partnership v. Commissioner,* T.C. Memo 1998-305. In this case, AlliedSignal used the Merrill Lynch plan to generate losses to offset a 1990 $400 million capital gain. AlliedSignal and its new wholly owned subsidiary ASIC entered into a partnership with two Netherlands Antilles special purpose corporations (which ABN controlled). In April 1990, the partnership bought $850 million in PPNs. One month later, it sold the PPNs for $681.3 million and 11 Libor notes; the total value was approximately $850 million. The partnership reported a $539,443,361 gain on its partnership return, allocated according to the partnership interests--$485 million to the foreign entities and $53 million to AlliedSignal and ASIC. The foreign entities paid no U.S. income tax. After the close of the first tax year, AlliedSignal acquired a majority partnership interest by purchasing part of the foreign entities' interest.

In August 1990, ASA distributed the Libor notes to AlliedSignal and ASIC in partial redemption of their partnership interest and cash and commercial paper to the foreign entities. The Libor notes carried an adjusted basis of $709 million (five-sixths of the basis of the PPNs). Allied sold some of the Libor notes in 1990 and the remainder in 1992, claiming a total loss of $ 538 million. It used the losses to offset the gain from the sale of its interest in another company. Although AlliedSignal reported a tax loss of $538 million, its actual economic profit was about $3.6 million.

The Service audited the partnership returns for 1990 through 1992, determining that ASA was not a valid partnership and adjusted the returns to allocate all gains and losses to AlliedSignal. The Tax Court focused on the purported business purpose of AlliedSignal and ABN. Allied entered into the venture for the sole purpose of generating capital losses, and ABN entered into it solely to receive its expected return. Allied bore all the expenses, and ABN did not intend to, nor did it actually, share in ASA's losses. The Tax Court concluded the relationship between the two was merely a contractual, debtor-creditor relationship--not a partnership.

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ASA Investerings Partnership

The Tax Court's opinion was affirmed by the Court of Appeals for the District of Columbia. *ASA Investerings Partnership v. Commissioner*, 201 F.3d 505 (D.C. Cir. 2000). Although the appellate court wrote that parties with different business goals are not precluded from having the intent required to form a partnership, the court affirmed the Tax Court's holding that the arrangement between the parties was not a valid partnership, in part because "[a] partner whose risks are all insured at the expense of another partner hardly fits within the traditional notion of partnership." *Id.* at 515. The appellate court rejected the taxpayer's argument that the test for whether a partnership is valid differs from the test for whether a transaction's form should be respected, writing that "whether the 'sham' be in the entity or the transaction . . . the absence of a nontax business purpose is fatal." *Id.* at 512.

SABA Partnership

A third Merrill Lynch installment sale case involved Brunswick Corp.'s ("Brunswick") decision to divest some of its businesses. *SABA Partnership v. Commissioner*, T.C. Memo 1999-359. The company expected a $125 million gain and met with Merrill Lynch to get help minimizing the tax impact.

Merrill Lynch proposed a transaction involving the creation of two partnerships (SABA and Otrabanda) to generate capital losses to offset the gains. Brunswick and a foreign bank formed these two partnerships, with PPNs and certificates of deposit (CDs). Within a month the partnerships sold the PPNs and CDs for cash and LIBOR notes in transactions structured to satisfy the requirements of contingent installment sales. Due to the partnerships' capital contributions, 90 percent of the gains were allocated to the foreign bank, which was not subject to U.S. income tax. After the partnerships' tax year, the bank's partnership interests were reduced through direct purchases by Brunswick and redemptions by the partnerships. The partnerships distributed cash to the bank and the LIBOR notes to Brunswick, which sold the notes for cash. Brunswick reported capital losses of $175 million on its 1990-1991 tax returns. Brunswick argued that an economic substance analysis wasn't warranted and that it should be required to show only that the transactions resulted in contingent sales of the PPNs/CDs under IRC §§ 1001(a) and 453(a).

The Tax Court revisited *Gregory* and applied the principle that although a business transaction may be structured in strict compliance with the law, a court is not obliged to respect its form when the record shows the transaction was contrived to obtain a tax benefit Congress did not intend. The

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SABA Partnership

partnerships had been organized to generate losses for Brunswick. The transactions did not change the company's economic position, and they lacked economic substance. Therefore, the company should not recognize any gains or losses on the sales of the PPNs or CDs. The Court rejected the argument that the transaction had a non-tax business purpose. *Saba Partnership v. Commissioner*, T.C. Memo 1999-359.

The D.C. Circuit Court vacated and remanded the case to the Tax Court, in light of its recent decision in *ASA Investerings Partnership v. Commissioner*. *Saba Partnership v. Commissioner*, 273 F.3d 1135 (D.C. Cir. 2001). The Court dismissed the argument that the transactions had economic substance and concluded that the *ASA Investerings Partnership* case made it clear that the absence of a non-tax business purpose was fatal to the argument that the Service should respect an entity for tax purposes. Refusing to affirm on the basis of *ASA Investerings Partnership*, the court noted that the record strongly suggested that the partnerships were sham partnerships organized to generate tax losses for Brunswick, and fairness dictated that the court ought not to affirm on this ground. *Saba Partnership*, 273 F.3d at 1141.

The Tax Court revisited *Gregory* and applied the principle that although a business transaction may be structured in strict compliance with the law, a court is not obliged to respect its form when the record shows the transaction was contrived to obtain a tax benefit Congress did not intend. The partnerships had been organized to generate losses for Brunswick. The transactions did not change the company's economic position, and they lacked economic substance. Therefore, the company should not recognize any gains or losses on the sales of the PPNs or CDs. The Court rejected the argument that the transaction had a non-tax business purpose. *Saba Partnership v. Commissioner*, T.C. Memo 1999-359.

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COLI Cases

A number of recent court opinions have addressed whether certain broad-based company-owned-life-insurance ("COLI") transactions had sufficient economic substance and business purpose to permit the owners of the underlying policies to deduct interest incurred on policy loans under IRC § 163. In each case, the court concluded that the COLI plans at issue lacked economic substance and business purpose.

Winn-Dixie

The first of these cases originated in the Tax Court in 1999. *See Winn-Dixie Stores, Inc. ("Winn-Dixie") v. Commissioner,* 113 T.C. 254 (1999), *aff'd per curiam,* 254 F.3d 1313 (11th Cir. 2001), *cert. denied,* 122 S.Ct. 1537 (2002). In 1993, the Winn-Dixie (the taxpayer) purchased a COLI plan whose sole purpose, as shown by contemporary memoranda, was to satisfy Winn-Dixie's "appetite" for interest deductions. Under the program, Winn-Dixie purchased whole life insurance policies on almost all of its full-time employees, who numbered about 36,000. Winn-Dixie was the sole beneficiary of the policies, and it was able to borrow against the policies' account value at an interest rate of over 11.06 percent Under the program, the insurer provided Winn-Dixie with a loaned crediting rate of 10.66 percent on leveraged cash values, thereby producing a fixed spread of 40 basis points. In contrast, the insurer provided Winn-Dixie with a crediting rate of 4 percent on unborrowed cash values.

The promoters of the COLI plan in Winn-Dixie provided the taxpayer with detailed projections of costs and benefits expected from the plan over a 60-year period. Particularly, the projections indicated that, during each policy year, the plan would generate a pre-tax loss and a significant after-tax profit, attributable to deductions for policy loan interest and administrative fees. The plan contemplated that the taxpayer would maintain little net equity in the policies, relative to the size of the plan.

In essence, the high interest and the administrative fees that came with the program outweighed the net cash surrender value and benefits paid on the policies, with the result that in pretax terms Winn-Dixie lost money on the program. The deductibility of the interest and fees post-tax, however, yielded a benefit projected to reach into the billions of dollars over 60 years. Winn-Dixie participated until 1997, when a change in tax law jeopardized this tax arbitrage.

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Winn-Dixie

The Service determined a deficiency because of the interest and fee deductions taken in Winn-Dixie's 1993 tax year. Winn-Dixie challenged the determination before the Tax Court. The Tax Court first addressed whether the COLI plan possessed sufficient objective economic substance. The Court found that the taxpayer did not purchase the plan to provide death benefit protection, noting the large number of geographically dispersed insured and the fact that the employees remained insured even after their employment was terminated. *Winn-Dixie*, 113 T.C. at 284-85. The Court further observed that, although there would be some variation between the anticipated and actual mortality of the 36,000 insured, such variations were not expected to significantly affect the plan. Viewing the COLI plan as a whole, and noting the annual discrepancy between pre-tax losses and after-tax profits set forth in the promotional material, the court found that the plan's only function was to reduce the taxpayer's income tax liability. *Id.* at 285. Thus, the Court concluded the plan lacked economic substance.

The Tax Court next addressed whether the taxpayer had a sufficient subjective business purpose for entering into the COLI transaction. The Court rejected the taxpayer's argument that its business purpose for entering into the transaction was to generate funds to pay for the increasing cost of its employee benefits program, which included limited death benefits. The Court further explained that there was no indication that the COLI policies were tailored to fund the taxpayer's employee benefit plan, and that employees remained insured after they left the taxpayer's employ. *Id.* at 286. In addition, the Court explained that even if the taxpayer had earmarked the COLI plan's tax savings to fund its employee benefits, that would not be sufficient to "breathe substance" into the transaction. Otherwise, reasoned the court, "every sham tax shelter device might succeed." *Id.* at 287. Moreover, the Court noted that the taxpayer was offered an "exit strategy" to terminate the plan if new legal limitations were imposed upon taxpayer's interest deductions, thereby suggesting that the purported business purpose for the plan was not sufficient to maintain the plan without the plan's tax benefits. *Id.* at 288-89. Thus, the Court concluded that the COLI plan served no business purpose for the taxpayer, other than to reduce its taxes.

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Winn-Dixie

The taxpayer in *Winn-Dixie* appealed to the Eleventh Circuit Court of Appeals, which affirmed the Tax Court's decision per curiam; and, the Supreme Court recently denied its petition for writ of certiorari. *Winn-Dixie Stores, Inc. v. Commissioner,* 113 T.C. 254 (1999), *aff'd per curiam,* 254 F.3d 1313 (11th Cir. 2001), *cert. denied,* 122 S.Ct. 1537 (2002).

C.M. Holdings, Inc. and American Electric Power, Inc.

The next opinions to address broad-based COLI transactions are *I.R.S. v. C.M. Holdings, Inc. ("C.M. Holdings")*, 254 B.R. 578 (D. Del. 2000), aff'd 2002 U.S. App. LEXIS 17171 (3rd Cir. 2002), and *American Electric Power, Inc. v. United States ("A.E.P.")*, 136 F. Supp.2d 762 (S.D. Ohio 2001), which involved similar COLI transactions based upon policies issued by the same insurer. In *C.M. Holdings* and *A.E.P.*, the taxpayers purchased COLI plans comprised of 1,430 and approximately 20,000 policies, respectively. The COLI plans in *C.M. Holdings* and *A.E.P.*, in similar fashion to the COLI plan in Winn-Dixie. contemplated a scheme whereby the taxpayers would systematically borrow from the policies to pay premiums. The taxpayers in *C.M. Holdings* and *A.E.P.*, before purchasing the COLI plans, received financial illustrations indicating that the COLI plans would generate annual pre-tax losses and significant after-tax profits, primarily attributable to deductions for policy loan interest. The courts in both cases described the features of the plans as follows: (1) high policy value on the first day of the policy; (2) maximum policy loans used to pay high premiums during the first three policy years; (3) zero net equity and maximum borrowing at the end of each policy year, perfected through the use of computer programs; (4) a variable interest rate provision whereby the taxpayer could choose the interest rate that it paid on policy loans; (5) a fixed spread between the policy loan rate and the loaned crediting rate, "with the counterintuitive result" that the higher the loan interest rate paid by the taxpayer, the greater the cash flow due to increased tax deductions; and (6) extremely high expense load components for the fourth through seventh policy years, which were used to create policyholder dividends that could be used to pay premiums. *A.E.P.*, 136 F.Supp at 777-78; *C.M. Holdings*, 254 B.R. at 596-97.

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C.M. Holdings, Inc. and American Electric Power, Inc.

In addressing whether the COLI plans at issue lacked objective economic substance, the courts in *C.M. Holdings* and *A.E.P.* compared the plans' economic effects on a pre-tax and after-tax basis. The courts first noted that, according to the financial illustrations provided to the taxpayers before they purchased the COLI plans, the plans were projected to generate negative pre-tax cash flows and positive after-tax cash flows over the life of the plans. *A.E.P.*, 136 F.Supp at 787-88; *C.M. Holdings*, 254 B.R. at 631-32. The courts further explained that the taxpayers did not expect to derive material economic gain from the non-tax beneficial components of the COLI plans, i.e., tax deferred inside build-up and tax-free death benefits. *A.E.P.*, 136 F.Supp at 787-88; *C.M. Holdings*, 254 B.R. at 631-32. In addition to addressing whether the taxpayer sought to generate inside build-up and receive death benefits in excess of cost, the *A.E.P.* court expressed particular concern that the parties, in designing the policies' interest rate provisions, exploited a loophole in the NAIC model bill, in an attempt to ensure that the taxpayer would always pay a policy loan interest rate in excess of the Moody's Corporate Average Rate. *A.E.P.*, 136 F.Supp at 789-790. Thus, the courts in *C.M. Holdings* and *A.E.P.* concluded that the COLI plans lacked economic substance.

In addition to the economic substance argument, the *C.M. Holdings* and *A.E.P.* courts addressed the parties' subjective business purpose for entering into the COLI transactions. The taxpayer in *C.M. Holdings* argued that it entered into the COLI transaction for the legitimate purpose of providing for the increasing cost of its employees' medical benefits, whereas the taxpayer in *A.E.P.* argued that it entered into the COLI transaction for the legitimate purpose of offsetting the cost of implementing FAS 106. Both courts rejected the taxpayers' arguments, emphasizing that the business purpose test is whether the underlying transaction has a legitimate purpose, not whether the taxpayer has a legitimate use for the after-tax cash flows generated by the transaction. *A.E.P.*, 136 F.Supp at 791-92; *C.M. Holdings*, 254 B.R. at 638. The Court in C.M. Holdings particularly noted the taxpayer's concern with pending tax legislation, manifested by a "honeymoon letter" and an attempt to execute the transaction before Congressional hearings on COLI began, as further indication that the COLI plan's critical feature was its ability to generate interest deductions. *C.M. Holdings*, 254 B.R. at 640. Thus, finding that the earnings generated by the COLI plans were tax-driven, the courts concluded that the plans served no legitimate business purpose.

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C.M. Holdings, Inc. and American Electric Power, Inc.

The Third Circuit sustained the district court's determination in CM Holdings, agreeing that the COLI program was a sham for tax purposes. Although not impacting on the disallowance of the $13.8 million in interest deductions, the Circuit Court held that the loading dividends were not factual shams, since the transactions actually occurred, but that the fact that the dividends are not industry practice was evidence of a sham. The court also affirmed the imposition of the penalties for substantial understatement. *IRS v. CM Holdings, Inc. (In re CM Holdings, Inc.),* 2002 U.S. App. LEXIS 17171 (3d Cir. 2002).

Rice's Toyota World

In *Rice's Toyota World, Inc. v. Commissioner ("Rice's Toyota World"),* 752 F.2d 89, 91-92 (4th Cir. 1985), *aff'g* 81 T.C. 184 (1983), the taxpayer purchased a used computer from the seller, gave the seller a recourse note and two non-recourse notes on the computer, and leased the computer back to the seller. The taxpayer paid off the recourse note and claimed depreciation deductions based on ownership and interest deductions for payments on the note. The Service disallowed all depreciation deductions and interest expense deductions based on the recourse and non-recourse notes. The Tax Court upheld the disallowance, explaining that "the transaction was not motivated by a business purpose, was devoid of economic substance, and should be disregarded for Federal income tax purposes." *Rice's Toyota World,* 81 T.C. at 210.

The Fourth Circuit affirmed the finding of a sham transaction and disallowance of depreciation deductions based upon inclusion of the non-recourse and recourse note and interest deductions from non-recourse debt. The appellate court reversed the disallowance of interest deductions arising out of recourse debt, holding that transactions with economic substance could not be ignored, even if motivated by tax avoidance. *Rice's Toyota World,* 752 F.2d at 96.

Specifically, the Fourth Circuit held that it is appropriate for a court to engage in a two-part inquiry to determine whether a transaction has economic substance or is a sham that should not be recognized for income tax purposes. To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of a profit exists.
Id. at 91.

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UPS

United Parcel Service of America, Inc. v. Commissioner ("UPS"), T.C. Memo 1999-268, like most tax shelter cases, has a complicated fact pattern. UPS (the taxpayer) generally limits its liability for damages to goods in transit to $100, but customers may pay and UPS collects "excess value charges" (EVCs) to insure the packages for greater amounts. Prior to 1984, UPS retained all of the EVCs, paid all claims, and reported the income and deduction items on its return. Effective 1984, UPS restructured the manner in which it dealt with and reported EVCs. Although it did not change its practices for dealing with customers in handling receipts and claims, UPS began to remit the net EVCs (the total collected from customers and other shippers minus claims paid) to an unrelated insurance company (NUF), which in turn, after deducting certain fees, remitted the net EVCs as a reinsurance premium to OPL, a Bermudan insurance company. OPL had been formed by UPS and 97.33 percent of its stock was owned by UPS's 14,000 shareholders, who had received the OPL stock as a dividend in a taxable spin-off. The OPL stock was subject to restrictions on transfer. After this arrangement was established, UPS no longer reported as income any of the EVCs collected and remitted to NUF, which amounted to almost $100 million for 1984 alone. However, UPS performed the same EVC functions and activities that it had previously performed, and it remained responsible for bad debts or uncollectible items because neither NUF nor OPL had any control over the customers' premium payments.

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UPS

The Tax Court upheld the Service's determination that under the assignment of income doctrine UPS was taxable on the almost $100 million of EVCs paid to OPL in 1984, regardless of OPL's separate existence, which was accepted arguendo. *UPS,* T.C. Memo 1999-268. The Court found that the entire 1984 arrangement lacked business purpose and economic substance. The Court rejected UPS's proffered business purpose - that its continued receipt of EVCs was potentially illegal under various state insurance laws - because no state insurance regulator ever questioned the prior practice. UPS never sought legal advice on the issue, Federal common carrier law probably preempted state law in any event, and if Federal law did not preempt state law, the 1984 practice was probably as violative of state law as the pre-1984 practice. The Court also was not convinced that the arrangement was designed to facilitate UPS rate increases. Nor was it impressed by UPS's claim that a business purpose was to leverage the excess value profits into a new reinsurance company; the opinion noted that "any investment of money into [the subsidiary reinsurer] could accomplish this purpose." *UPS,* T.C. Memo 1999-268. After examining UPS's pre-1984 reinsurance practices, which involved only claims over $25,000, and the fairly consistent 70 percent ratio of net EVCs retained to total EVCs collected, the Court rejected the UPS claim that the NUF/OPL arrangement sufficiently reduced the risk to UPS core transportation activity assets to have economic substance. Finally, the court found that there was contemporaneous documentation that the transaction was tax-motivated and concluded that the arrangement was "done for the purpose of avoiding taxes" and "had no economic substance or business purpose." *Id.* Because the EVC restructuring was found to be a sham transaction, the court denied UPS's deduction for approximately $1 million retained by NUF.
On appeal, the Eleventh Circuit considered whether the restructured insurance program had enough substance and business purpose to meet the economic substance doctrine. *United Parcel Service of America, Inc. v. Commissioner ("UPS"),*254 F.3d 1014 (11th Cir. 2001). It defined the economic-substance doctrine as a two-pronged analysis. The first prong was whether the transaction had no other economic effects besides the creation of tax benefits. If a transaction passed the first prong and was found to have economic effects, then, according to the Eleventh Circuit, the analysis proceeded to the second prong.

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UPS

The second prong of the analysis provided that despite economic effects, the transaction had to be disregarded if it had no business purpose and its motive was tax avoidance. (The Eleventh Circuit noted that this approach differs from the approach taken in *Rice's Toyota World, Inc., 752 F2d 89,* which required both a tax-avoidance purpose and a lack of economic effects.)

Proceeding under the above analytical framework, the Eleventh Circuit found that the UPS insurance restructuring had economic effects. The Eleventh Circuit relied on *Frank Lyon Co., 435 U.S. 561 (1978),* and held that, despite NUF's slight risk of loss on the deal, the transaction still had economic effects, because it comprised genuine exchanges of reciprocal obligations enforceable by unrelated parties. *UPS,* 254 F.3d at 1018-20.

The Eleventh Circuit also considered the business-purpose and tax-avoidance motives, relying on *ACM Partnership v. Commissioner,* 157 F.3d 231 (3d Cir. 1998). The Eleventh Circuit explained that a transaction has business purpose as long as it figures in a bona fide profit-seeking business, and it emphasized that a valid business purpose does not require that the reasons for a transaction be free of tax considerations. *UPS,* 254 F.3d at 1019.

In concluding that the insurance restructuring had economic substance and business purpose, the Eleventh Circuit reversed and remanded for consideration in the first instance of other arguments not addressed by the Tax Court (concerning under IRC § 482 and transfer pricing provisions of the Code). *UPS,* 254 F.3d. at 1019-20.